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The impact of European Elections on France's bond market

PRIVATE BANKING

Executive Summary

- **Political and fiscal uncertainty:** the Rassemblement National's (RN) gains in the European elections introduce political and fiscal uncertainty into France's fixed income market. Key risks include potential policy shifts towards increased public spending, undermined investor confidence, and heightened market volatility.
- **Market reactions:** immediate market reactions have already seen selloffs in bonds, with increased yields on French government bonds (OATs) and a steepened yield curve. Foreign investors are particularly concerned about capital outflows and the broader economic implications within the Eurozone.
- **Credit rating downgrade:** the recent S&P downgrade highlights the need for careful monitoring of France's credit rating and its impacts on the fixed income market.
- **Future risks:** if the RN performs similarly in the upcoming legislative elections, the risk to France's bonds could intensify, driven by potential shifts in fiscal policy and sustained political uncertainty.

Current context

Following a poor performance by his centrist alliance in the European parliamentary elections, French President Emmanuel Macron has called for snap legislative elections. This move has significantly heightened political uncertainty, particularly given the substantial gains by Marine Le Pen's far-right Rassemblement National (RN), which secured a notable share of the vote. In this context, the market reacted swiftly to Macron's announcement, with significant selloffs in French stocks and bonds. The CAC 40 index fell by 1.4%, and the yield on 10-year OATs increased by 13 bps to 3.23%, its highest level in 2024, reflecting higher risk premiums.

Potential Risks and Implications for French Government Bonds

The recent gains by the RN in the European elections introduce significant political and fiscal uncertainty into France's fixed income market. Key risks and their direct implications for French government bonds include:

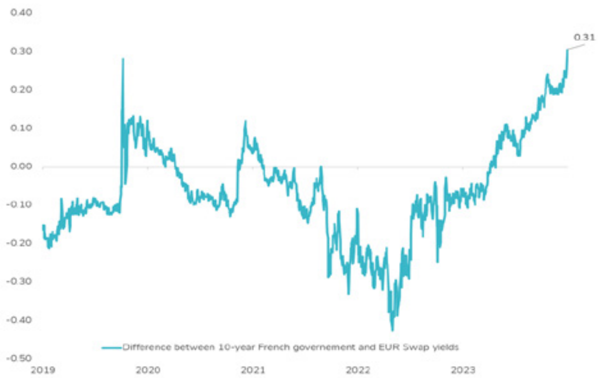
- **Increased Political and Fiscal Uncertainty:** The RN's platform, advocating increased public spending and opposition to key fiscal reforms such as pension adjustments, could heighten concerns about France's fiscal discipline. This may lead to higher perceived risks associated with French government bonds (OATs), resulting in rising yields as investors demand greater compensation for perceived risks. Political uncertainty is likely to widen OAT spreads relative to other Eurozone bonds, such as German Bunds.

Chart 1: France 10-year yield hit a 2024 high

Source: Syz CIO Office, Bloomberg

- **Potential Downgrade for Credit Rating:** S&P recently downgraded France's credit rating from AA to AA-, following a similar downgrade by Fitch last year. Moody's has indicated that the current situation negatively impacts the rating and may revise its outlook from stable to negative, potentially leading to another downgrade. This negative trend may add pressure to OAT yields and exacerbate investor concerns. Comparative upgrades of Ireland and Spain suggest France may be diverging negatively from other semi-core/peripheral countries. This downgrade could also contribute to a steepening of the yield curve, with long-term yields rise due to increased risk premiums.

Chart 2: The difference between the 10-year French and EUR swap yields has spiked



Source: Syz CIO Office, Bloomberg

- **Concerns Among Foreign Investors:** Given France's reliance on non-domestic investors, political uncertainty may prompt capital outflows. Increased yields on French bonds suggest investors seek higher returns to compensate for added risk. Japanese investors, who hold significant positions in OATs, may reduce their holdings due to rising domestic interest rates. Higher yields on Japanese bonds could attract more local investment, potentially reducing demand for OATs. Hedge funds increasing their bets against European government bonds indicates broader skepticism about the stability of European economies, including France.

Chart 3: Short positions on European Government bonds have risen this year to two-year highs

Source: Financial Times, S&P Global

- **ECB's Position:** The ECB is unlikely to preemptively change its policy unless there is clear evidence of significant economic deterioration. Policies proposed by the RN that could lead to inflationary pressures or fiscal instability may eventually prompt ECB intervention, affecting the broader Eurozone bond market.

Long-term Perspective

In the long-term perspective, while the widening of the spread between France and core and semi-core countries has been contained for now, this stability may be at risk depending on future political alliances. Should there be a coalition between President Macron and Jordan Bardella, the leader of the RN, it would introduce new variables into the political landscape. The main outcome could be an "ungovernable" government until the next presidential elections in 2027. This potential partnership could further complicate fiscal policy and investor sentiment, possibly leading to increased volatility in the fixed income market. As a result, investors may demand higher yields on French government bonds (OATs) to compensate for the increased risk, potentially causing long-term yields to rise more sharply due to the anticipated prolonged period of political and fiscal instability.

For further information

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